

STATE OF TENNESSEE

Office of the Attorney General



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Reply to:
Consumer Advocate and Protection Division
Post Office Box 20207
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July 11, 2003

Honorable Deborah Taylor Tate
Chairman
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, Tennessee 37243

RE: In Re: Petition of Tennessee American Water Company to Change and Increase Certain Rates and Charges So As to Permit it to Earn a Fair and Adequate Rate of Return on Its Property Used and Useful in Furnishing Water Service to Its Customers
Docket No. 03-00118

Dear Chairman Tate:

Enclosed is an original and thirteen copies of the Consumer Advocate & Protection Division of the Office of the Attorney General's Post-Hearing Brief in the above-referenced matter pursuant to the request by the TRA Directors hearing this matter on July 1, 2003. I would appreciate if this be filed in this docket. We are forwarding copies of same to all parties of record. If you have any questions, please feel free to contact me at (615) 532-3382. Thank you.

Sincerely,

A handwritten signature in black ink that reads "Shilina B. Chatterjee". The signature is fluid and cursive, with the first letters of the first and last names being capitalized and prominent.

Shilina B. Chatterjee
Assistant Attorney General

Enclosures

cc: All Parties of Record

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IN RE:

**PETITION OF TENNESSEE-
AMERICAN WATER COMPANY TO
CHANGE AND INCREASE CERTAIN
RATES AND CHARGES SO AS TO
PERMIT IT TO EARN A FAIR AND
ADEQUATE RATE OF RETURN ON
ITS PROPERTY USED AND USEFUL IN
FURNISHING WATER SERVICE TO
ITS CUSTOMERS**

CONSUMER ADVOCATE'S POST-HEARING BRIEF

(1) The “Option 1” rate design based on a revenue deficiency of \$1.6 million is the best rate design (this design is based on the TRA upholding its prior Order and finding that Tennessee-American is obligated to continue its \$1.1 million annual fire hydrant reduction to the City of Chattanooga);

(2) In the event the TRA reverses its prior Order regarding the \$1.1 million annual fire hydrant discount, residential and commercial consumers should not be forced to pay for this discount;

(3) RWE is the corporate parent of Tennessee-American Water Company and can

absorb any loss caused by continuing the fire hydrant discount; and

(4) A TRA decision to uphold its prior Order and continue the \$1.1 million fire hydrant discount would not prohibit Tennessee-American from earning a fair rate of return.

The Consumer Advocate and Protection Division has the statutory duty and authority to represent the interests of the consumers of Tennessee concerning public utility services. Tenn. Code Ann. §65-4-118 (c)(2)(A). The legislature granted this authority to the Consumer Advocate and also charged it with a duty to represent consumers in all public utility matters before the Authority and any other legislative, administrative or judicial body. Tenn. Code Ann. §65-4-118 (c)(2)(A). While the Consumer Advocate recognizes the concerns of Tennessee-American and the other parties, the Consumer Advocate is charged by law to defend the interests of Tennessee consumers. Just as counsel representing the other parties are vigorously serving their client's best interest, it is the duty and obligation of the Consumer Advocate to serve the consumers of the State of Tennessee in the same manner and ensure that consumers are not unreasonably and excessively charged for their water service in the State of Tennessee.

Any rate design that (1) is based on forcing consumers to pay for the \$1.1 million in revenues lost in granting the City of Chattanooga a fire hydrant discount and (2) imposes more than an across the board increase on all classes of customers is not in the best interests of residential and commercial consumers. Such an across the board increase would result in a 5.5% increase for residential and commercial consumers. Accordingly, the proposed rate design submitted by the other parties on June 30, 2003, as Exhibit 4 to the transcript and known as "Option 2", is not in the interest of Tennessee consumers and should not be adopted by the TRA. It imposes a 10.92% increase on residential consumers and a 9.86% increase in water service

rates for commercial consumers. For the reasons set forth below, such an increase is without any support in the record.

ISSUE 1

THE TRA SHOULD ADOPT THE "OPTION 1" RATE DESIGN BASED ON A REVENUE DEFICIENCY OF \$1.6 MILLION AND THE TRA UPHOLDING ITS PRIOR ORDER REGARDING THE \$1.1 MILLION FIRE HYDRANT REDUCTION

On June 27, 2003, the Consumer Advocate and Tennessee-American submitted a Proposed Settlement Agreement to the TRA. In this Settlement Agreement, the Consumer Advocate and Tennessee-American agreed that the revenue deficiency for Tennessee-American was either: "\$1,617,447 in the event the Tennessee Regulatory Authority continues to impute the reduction of the fire hydrant annual charges as ordered by the TRA in its response to the Company's petition to voluntarily reduce its annual price for public fire service from \$301.20 to \$50 per public fire hydrant, in TRA Docket No. 99-0891; or (2) \$2,745,411 in the event the TRA decides to reverse the imputation of the fire hydrant annual cost or otherwise approve an adjustment that would offset the loss in public fire service revenues." Proposed Settlement Agreement at Paragraph 2. As established by the proof in this case, the \$1.6 million revenue deficiency is the proper one in the event the TRA should continue to impute the \$1.1 million fire hydrant reduction as ordered in Docket No. 99-0891.

On the first day of the hearing, the City of Chattanooga and the Manufacturers Association, who were not signatories to the Proposed Settlement Agreement, agreed on the \$1.6 and \$2.7 million deficiency figures set forth in that Agreement. Then, in an attempt to completely settle the case, the parties met to discuss an acceptable rate design based on these two figures. The parties were unable to reach a full agreement, but were able to compromise their differences

as far as possible by formulating their positions into two “options” known as “Option 1” and “Option 2.”

Under Option 1, all the parties were able to come to an agreement as to rate design in the event that the TRA upholds its prior Order regarding the \$1.1 million annual fire hydrant reduction and continues to impute that \$1.1 million reduction to Tennessee-American. Essentially, this rate design would result in a 5.5% rate increase for consumers. Accordingly, the TRA should adopt Option 1 as filed with the TRA on June 30, 2003.

Option 2 involves determining who would pay if Tennessee-American is allowed to stop giving the City the \$1.1 million fire hydrant discount. The Consumer Advocate did not agree to the Option 2 rate design because this design would cause an unacceptable rate increase for consumers by shifting the \$1.1 million of fire protection costs to residential and commercial consumers.

If the TRA chooses the figure of \$1.6 million as the revenue deficiency, the Consumer Advocate agrees that residential and commercial customers should pay their pro rata share of the increase, which would amount to a 5.5% increase. Residential and commercial customers, however, should pay no more than their pro rata share.

During the hearing, witnesses for Tennessee-American attempted to demonstrate that residential and commercial customers were not paying their fair share on a “cost causer” basis. This “cost causer” proof, however, was inadequate. First, there was no conclusive proof that the residential and commercial customers were not paying their full share of costs. The study upon which Tennessee-American witness Herbert relied for his “cost causer” opinion did not use studies of actual loads placed on the system by classes of customers. Transcript at pages 120-

121. Instead, the witness relied upon data from out-of-state water companies, without any proof that these companies served cities with loads similar to Chattanooga. Transcript at page 116 and pages 120-121, 128.

Furthermore, witnesses for Tennessee-American had to acknowledge that the City of Chattanooga was not paying on a “cost causer” basis for its fire hydrant service. Transcript at page 115. In particular, the actual cost of fire hydrant service was approximately \$315, but the City was paying only approximately \$50. Transcript at page 115. Thus, there is no rational basis for holding one class of customers to a “cost causer” standard, while ignoring other classes.

Accordingly, the TRA should reject the testimony of any witness insofar as they attempt to argue that residential and commercial customers are not paying their fair share.

ISSUE II

RESIDENTIAL AND COMMERCIAL CONSUMERS SHOULD NOT BE FORCED TO PAY FOR THE FIRE HYDRANT DISCOUNT

In the year 2000, Tennessee-American and the City of Chattanooga reached an agreement to reduce the fire hydrant charges to the City of Chattanooga by \$1.1 million annually. This agreement was recognized and adopted by the TRA in its Order Approving Tariff, September 26, 2000, TRA Docket No. 99-00891. This agreement, however, did not provide any reduction of rates for consumers. Accordingly, in the event the TRA reverses its previous order and grants the \$1.1 million increase to Tennessee-American, residential and commercial consumers should not have to absorb the cost of the fire hydrant reduction merely because Tennessee-American is seeking to change the terms of their agreement with the City of Chattanooga.

As a result of this rate case filed by Tennessee-American, consumers already can expect an increase in their water service rates. As such, it would be an unreasonable and unfair burden for residential and commercial consumers to shoulder an additional increase in their rates.

If, however, Tennessee-American is awarded the additional \$1.1 million they are seeking to make up for the reduction in rates of the fire hydrants to the City of Chattanooga, the rate design determined by the TRA should not impose upon residential and commercial consumers additional charges to make up the \$1.1 million deficiency. Such an imposition of charges would essentially mean that these consumers would be subsidizing Tennessee-American and the City of Chattanooga and there is no sufficient justification for this in the record. **It must be remembered that residential and commercial consumers were never a part of the arrangement between Tennessee-American and City of Chattanooga concerning the fire hydrant fees.** Furthermore, Tennessee-American has reaped and continues to reap the benefit of avoiding a condemnation lawsuit by agreeing to the \$1.1 million annual fire hydrant reduction. Therefore, it would be inherently unfair to impose payment for the discount of the fire hydrants upon these residential and commercial consumers. Accordingly, the Consumer Advocate opposes any proposal that the residential and commercial class pay any of the \$1.1 million amount attributable to the fire hydrant settlement between Tennessee-American and the City of Chattanooga in the event the TRA reverses its prior Order.

ISSUE III

RWE IS THE CORPORATE PARENT OF TENNESSEE-AMERICAN WATER COMPANY AND BY ITS PURCHASE OF TENNESSEE-AMERICAN HAS ACCEPTED THE \$1.1 MILLION FIRE HYDRANT REDUCTION AND ITS POSSIBLE RAMIFICATIONS INCLUDING THE NEED FOR A CAPITAL INFUSION

When RWE bought Tennessee-American, the agreement between the City of Chattanooga and Tennessee-American was a matter of public record as well as a topic for any due diligence study preparatory to buying the company. If the TRA stands by its Order of September 23, 2000, and continues to protect residential and commercial consumers from bearing the cost of the \$1.1 million fire hydrant reduction, Tennessee-American's parent company RWE will also continue to bear the \$1.1 million discount, just as it has done to date after having the opportunity to learn of the \$1.1 million reduction through the public record or due diligence. Furthermore, if RWE chooses not bear the discount it has the option to infuse additional capital into its subsidiary Tennessee-American, thereby increasing its investment in plant used to deliver water service.

As of January 2003, American Water Works Company, Inc. (parent corporation of Tennessee-American) ceased to be a publicly traded corporation, with the acquisition of all common stock of American Water Works Company, Inc., by RWE AG.¹ At present, RWE now manages the American Water Works Company, Inc., operating the former's subsidiaries in the U.S. and Canada.²

The common stock of Tennessee-American is wholly owned by American Water Works.

¹ American Water Works Annual Report, p. 1.

² American Water Works Annual Report, p. 1.

All of the common stock of American Water Works is held by the Thames Water Corporation, which in turn is wholly owned by RWE AG. Tennessee American Water Company, through a parent subsidiary relationship, is owned lock, stock and barrel by RWE. In essence, RWE is the sole stockholder of Tennessee-American.

RWE is the third largest water corporation in the world. With the purchase of the American Water Works Company, RWE obtained regulated water companies in 18 states throughout the United States. Between January 2002 and the beginning of 2003, eleven subsidiaries of American Water Works were authorized by state commissions for rate increases that totaled over \$31.1 million annually.³

Pursuant to the Order issued by the TRA on September 26, 2000, the ratepayers are not to pay for the fire hydrant discounts that were passed along to the City of Chattanooga. Therefore, RWE should absorb the loss as the stockholder. Officials from Tennessee-American represented to the TRA on January 11, 2000, that the loss resulting from the fire hydrant settlement would be made up by new customers in residential, commercial, industrial areas and from the sale of water to surrounding water utilities. (Hearing Transcript, January 11, 2000, pp. 17-19). The TRA further stated that based upon the companies's representations, any loss was being absorbed by the "stockholders" (Hearing Transcript, January 11, 2000. p. 32).

³

American Water Works Annual Report, p. 5.

ISSUE IV

A TRA DECISION NOT TO IMPUTE THE \$1.1 MILLION FIRE HYDRANT DISCOUNT WOULD NOT PROHIBIT TENNESSEE-AMERICAN FROM EARNING A FAIR RATE OF RETURN

Witness Gorman for the Chattanooga Manufacturer's Association testified that Tennessee-American could write off any impaired assets in order to avoid the possibility of earning less than a fair rate of return. Transcript at pages 145-147. Michael Gorman, a regulatory and economic consultant, stated that there was an alternative for Tennessee-American concerning the \$1.1 million revenue deficit that they were facing regarding the fire hydrant reduction. Mr. Gorman stated that since the company had previously agreed to accept the \$1.1 million in reduced revenue from the City of Chattanooga under the settlement agreement and final Order of the TRA concerning the fire hydrant service, that meant that part of their plant was impaired as a result of the agreement, and Tennessee-American could write that portion of the plant down in their accounting records to reflect the amount of the impairment. (Transcript, June 30, 2003, p. 146, lines 1-10). Additionally, Tennessee-American's common equity balance would be written down to reflect the plant impairment. This accounting convention would cure the earning deficiency for not recovering the full revenue needed to support the fire hydrant service. (Transcript, June 30, 2003, p. 146, lines 11-17). To cure any possible credit rating impact, Mr. Gorman suggested that Tennessee-American's parent, RWE, grant Tennessee-American an equity infusion to restore the common equity that resulted from writing down the impaired plant or Tennessee-American could suspend their common dividends to restore their common equity. (Transcript, June 30, 2003, p. 146, lines 18-25). Thereafter, from funds generated by the equity infusion of its parent, RWE, or the suspension of dividends, Tennessee-

American could pay off debt and retire it. (Transcript, June 30, 2003, p. 146, line 25 - p. 147, line 3).

This write-down of plant is acceptable because they are "impaired" due to the company's agreement to reduce the revenue stream generated by these assets. (Transcript, June 30, 2003, p.146, lines 7-10). As a result of Tennessee-American's agreement to compromise the condemnation suit by the City, the present value of fire hydrant service is below its book value, and the company can take a write-off in order to lower the assets to their appropriate value. Thus, the proposal that Tennessee-American write down their plant assets to cure a possible revenue deficiency is a viable alternative for Tennessee-American.

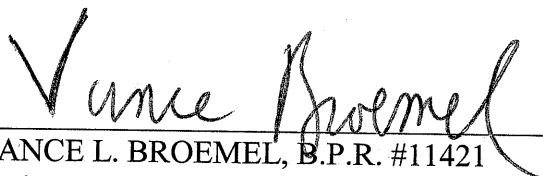
Additionally, it would not take a long period of time for Tennessee-American to write off the revenue deficiency from the fire hydrants. Mr. Gorman stated that it could be cured within a single year, after which the company's earnings would be restored to their normal level. (Transcript, June 30, 2003, p. 153, lines 23-24 - p. 154, lines 1-6). Moreover, their credit rating would not be impacted because as Mr. Gorman noted, the credit analysts would recognize this as a one-time event that was caused only because the company agreed to it and, accordingly, there would not be any impairment to its credit quality at all. (Transcript, June 30, 2003, p. 154, lines 15 - 19).

The write-off proposed by Gorman was not rebutted by Tennessee-American. Tennessee-American attempted to rebut it, but witness Miller was unable to state that the "write-off" would drop the company below a fair rate of return on a percentage basis. Transcript at page 188.

CONCLUSION

For the foregoing reasons, the TRA should find that the "Option 1" rate design based on a revenue deficiency of \$1.6 million is the best rate design (this design is based on the TRA upholding its prior Order and finding that Tennessee-American is obligated to continue its \$1.1 million annual fire hydrant reduction to the City of Chattanooga).

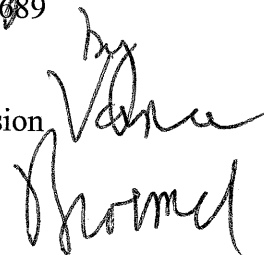
RESPECTFULLY SUBMITTED,



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Dated: July 11, 2003

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CERTIFICATE OF SERVICE

I hereby certify that a true and exact copy of the foregoing has been forwarded by first-class mail, postage prepaid, to all parties of record on this 11th day of July, 2003.



SHILINA B. CHATTERJEE
Assistant Attorney General